



STATE OF ALASKA
GROUP HEALTH AND LIFE FUND
(An Internal Service Fund of the State of Alaska)

Financial Statements

June 30, 2003 and 2002

(With Independent Auditors' Report Thereon)

STATE OF ALASKA
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(An Internal Service Fund of the State of Alaska)

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Independent Auditors' Report

Division of Retirement and Benefits
Group Health and Life Fund:

We have audited the accompanying statements of net assets of the State of Alaska Group Health and Life Fund (Plan), an Internal Service Fund of the State of Alaska, as of June 30, 2003 and 2002, and the related statements of revenues, expenses and changes in net assets, and cash flows for the years then ended. These financial statements are the responsibility of the Plan's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As discussed in note 1, the financial statements present only the State of Alaska Group Health and Life Fund and do not purport to and do not present fairly the financial position of the State of Alaska as of June 30, 2003 and 2002, changes in its financial position and cash flows, where applicable, for the years then ended in conformity with accounting principles generally accepted in the United States of America.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the State of Alaska Group Health and Life Fund, an Internal Service Fund of the State of Alaska, as of June 30, 2003 and 2002, and the changes in its financial position and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

The accompanying required supplementary information of management's discussion and analysis on pages 2 to 5 is not a required part of the basic financial statements but is supplementary information required by accounting principles generally accepted in the United States of America. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the required supplementary information. However, we did not audit the information and express no opinion on it.

KPMG LLP

September 26, 2003



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STATE OF ALASKA
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Management's Discussion and Analysis

This section presents management's discussion and analysis (MD&A) of the Group Health and Life Fund's (Plan) financial condition and performance for the year ended June 30, 2003. This section is presented as a narrative overview and analysis. Please read the MD&A in conjunction with the financial statements and notes to the financial statements to better understand the financial condition and performance of the Plan during the fiscal year ended June 30, 2003. Prior fiscal years' information is presented for comparative purposes.

Financial Highlights

The Plan's total current assets exceeded its total current liabilities by \$8,584,430 and \$5,288,026 at the close of Fiscal Years 2003 and 2002, respectively.

The Plan's net assets as of June 30, 2003 and 2002 increased by \$3,296,404 and \$4,328,838 or 62.3% and 451.3% over the closing balances of those assets in Fiscal Years 2002 and 2001, respectively.

Total health premiums received totaled \$51,902,080 and \$47,037,462 during Fiscal Years 2003 and 2002, respectively; reflecting an increase of \$4,864,618 or 10.3% and a decrease of \$47,914,729 or 50.5% from Fiscal Years 2002 and 2001, respectively.

Investment earnings increased from \$642,317 to \$714,581 during Fiscal Year 2003 and decreased from \$2,119,281 to \$642,317 during Fiscal Year 2002; reflecting an increase of 11.3% and a decrease of 69.7% from Fiscal Years 2002 and 2001, respectively.

Benefit payments totaled \$46,575,690 and \$41,809,709 during Fiscal Years 2003 and 2002, respectively; reflecting an increase of \$4,765,981 or 11.4% and a decrease of \$48,287,794 or 53.6% from Fiscal Years 2002 and 2001, respectively.

Overview of the Financial Statements

This discussion and analysis is intended to serve as an introduction to the Plan's basic financial statements. The Plan's basic financial statements are comprised of four components: (1) statement of net assets, (2) statement of revenues, expenses and changes in net assets, (3) statement of cash flows, and (4) notes to the financial statements.

Statement of Net Assets – This statement presents information regarding the Plan's assets, liabilities, and net assets. Net assets represent the total amount of assets less the total liabilities. The Statement of Net Assets classifies assets, liabilities and net assets as current, non-current and restricted.

Statement of Revenues, Expenses and Changes in Net Assets – This statement presents how the Plan's net assets changed during the fiscal year as a result of health premiums, investment income, operating expenses, and changes in net assets.

Statement of Cash Flows – This statement presents cash flows from operations, non-capital financing, and investing activities. The Plan presents its cash flows statement using the direct method for reporting cash received and disbursed during the fiscal year.

The above statements represent resources available for investment and the payment of benefits as of the fiscal year-end and the sources and uses of those funds during the fiscal year.

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Management's Discussion and Analysis

Notes to the Financial Statements – The notes to the financial statements are an integral part of the financial statements and provide additional detailed information to better understand the Plan's financial statements.

Condensed Financial Information

GROUP HEALTH AND LIFE FUND
NET ASSETS

<u>Description</u>	<u>2003</u>	<u>2002</u>	<u>Increase/(Decrease)</u>		<u>2001</u>
			<u>Amount</u>	<u>%</u>	
Assets:					
Cash and cash equivalents	\$ 15,806,969	12,336,017	3,470,952	28.1%	17,493,753
Receivables	51,916	119,187	(67,271)	(56.4%)	717,749
Total assets	15,858,885	12,455,204	3,403,681	27.3%	18,211,502
Liabilities:					
Estimated claims incurred but not paid	6,750,000	7,020,000	(270,000)	(3.8%)	16,310,000
Accrued expenses	524,455	147,178	377,277	256.3%	942,314
Total liabilities	7,274,455	7,167,178	107,277	1.5%	17,252,314
Total net assets	\$ 8,584,430	5,288,026	3,296,404	62.3%	959,188

CHANGES IN NET ASSETS

Net assets, beginning of year	\$ 5,288,026	959,188	4,328,838	451.3%	3,836,455
Operating revenues:					
Health premiums	51,902,080	47,037,462	4,864,618	10.3%	94,952,191
Other revenues	84,404	343,638	(259,234)	(75.4%)	672,511
Total operating revenues	51,986,484	47,381,100	4,605,384	9.7%	95,624,702
Operating expenses:					
Benefits	46,575,690	41,809,709	4,765,981	11.4%	90,097,503
Administrative expenses	2,828,971	3,169,814	(340,843)	(10.8%)	6,173,747
Total operating expenses	49,404,661	44,979,523	4,425,138	9.8%	96,271,250
Operating income (loss)	2,581,823	2,401,577	180,246	7.5%	(646,548)
Nonoperating revenues:					
Investment income	714,581	642,317	72,264	11.3%	2,119,281
Income before transfers	3,296,404	3,043,894	252,510	8.3%	1,472,733
Transfer from (to) ASEA/AFSCME Local 52 Health Benefit Trust	—	1,284,944	(1,284,944)	(100.0%)	(4,350,000)
Changes in net assets	3,296,404	4,328,838	(1,032,434)	(23.9%)	(2,877,267)
Net assets, end of year	\$ 8,584,430	5,288,026	3,296,404	62.3%	959,188

Management's Discussion and Analysis

The Statement of Net Assets at the close of June 30, 2003 and 2002 showed total assets exceeding total liabilities by \$8,584,430 and \$5,288,026, respectively. These amounts represent the total plan assets held in trust for healthcare benefits on each of those dates. The entire amount is available to cover the Plan's obligations to pay health care benefits for its members and their beneficiaries.

Premium Calculations

Premiums and Income

Revenues					
	FY03	FY02	Increase/(Decrease)		FY01
			Amt	%	
Health insurance premiums	\$ 51,902,080	47,037,462	4,864,618	10.3%	94,952,191
Other income	84,404	343,638	(259,234)	(75.4%)	672,511
Investment income	714,581	642,317	72,264	11.3%	2,119,281
Total	\$ 52,701,065	48,023,417	4,677,648	9.7%	97,743,983

Health benefit premium credits increased from \$490 per year per person during Fiscal Year 2001 to \$575 per year per person during Fiscal Year 2002 to \$630 during Fiscal Year 2003. Investment income increased by \$72,264 or 11.3% over amounts recorded in Fiscal Year 2002, thereby providing a substantial boost to increase net assets of the Plan over the same period. Investment income decreased by \$1,476,964 or 66.7% over amounts recorded in Fiscal Year 2001. While it was a decrease, there was still a modest return on the Plan's assets. Other income decreased as the Plan did not receive as much in prescription drug rebates as in the two previous years.

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Benefits and Expenses

The primary expense of the Plan is the payment of healthcare benefits. These benefit costs and the cost of administering the Plan comprise the costs of operation.

	Expenses				FY01
	FY03	FY02	Increase/(Decrease) Amt	%	
Healthcare benefits	\$ 46,575,690	41,809,709	4,765,981	11.4%	90,097,503
Administrative expenses	2,828,971	3,169,814	(340,843)	(10.8%)	6,173,747
Total	\$ 49,404,661	44,979,523	4,425,138	9.8%	96,271,250

Benefit payments had increases of \$4,765,981 or 20.7% and decreases of \$48,287,794 or 53.6% from Fiscal Years 2002 and 2001, respectively. In Fiscal Year 2001, the General Government Unit (GGU) collective bargaining unit was in the Plan. Effective July 1, 2001, GGU received health care coverage through their union trust.

With health care cost continuing to trend higher, further increases to healthcare benefit payments are expected. The Plan's benefit consultants had identified and developed premiums necessary to cover the increased claims costs.

Economic Conditions, Market Environment, and Results

The overall objective of the Plan is to have sufficient funds to meet claim costs. The premiums are calculated each fiscal year based on the anticipated claims and administrative costs for the following year. The benefit consultant reviews the historical claims experience and administrative costs and uses that data to estimate trends to develop premiums for the next fiscal year.

Requests for Information

This financial report is designed to provide a general overview of the Plan's financial condition for those with interest in the Plan's finances. Questions concerning any of the information provided in this report or requests for additional financial information should be addressed to the State of Alaska, Division of Retirement & Benefits, Accounting Section, P.O. Box 110203, Juneau, Alaska 99811-0203.

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Statements of Net Assets

June 30, 2003 and 2002

	<u>2003</u>	<u>2002</u>
Current assets:		
Cash and cash equivalents:		
Investment in State of Alaska General Fund and other		
non-segregated investments pool (notes 3 and 6)	\$ 15,806,969	12,336,017
Due from State of Alaska General Fund	—	81,180
Premiums receivable	<u>51,916</u>	<u>38,007</u>
Total current assets	<u>15,858,885</u>	<u>12,455,204</u>
Current liabilities:		
Estimated claims incurred but not paid (note 4)	6,750,000	7,020,000
Due to State of Alaska General Fund	58,372	—
Accrued expenses	<u>466,083</u>	<u>147,178</u>
Total current liabilities	<u>7,274,455</u>	<u>7,167,178</u>
Contingency (note 7)		
Unrestricted net assets	<u>\$ 8,584,430</u>	<u>5,288,026</u>

See accompanying notes to basic financial statements.

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Statements of Revenues, Expenses and Changes in Net Assets
Years ended June 30, 2003 and 2002

	<u>2003</u>	<u>2002</u>
Operating revenues:		
Health insurance premiums	\$ 51,902,080	47,037,462
Other	84,404	343,638
Total operating revenues	<u>51,986,484</u>	<u>47,381,100</u>
Operating expenses:		
Benefits	46,575,690	41,809,709
Administrative expenses	2,828,971	3,169,814
Total operating expenses	<u>49,404,661</u>	<u>44,979,523</u>
Operating income	2,581,823	2,401,577
Nonoperating revenues:		
Investment income	714,581	642,317
Income before transfers	3,296,404	3,043,894
Transfer from ASEA/AFSCME Local 52		
Health Benefit Trust (note 5)	—	1,284,944
Change in net assets	3,296,404	4,328,838
Total net assets, beginning of year	<u>5,288,026</u>	<u>959,188</u>
Total net assets, end of year	<u>\$ 8,584,430</u>	<u>5,288,026</u>

See accompanying notes to basic financial statements.

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Statements of Cash Flows

Years ended June 30, 2003 and 2002

	<u>2003</u>	<u>2002</u>
Operating activities:		
Cash received for premiums within the states' entity	\$ 51,315,300	46,545,435
Cash received from others for premiums	572,871	510,590
Cash received from third-party administrator	84,404	877,050
Cash payments to third-party administrator for benefits	(46,539,661)	(51,392,915)
Cash payments to employees	(190,846)	(166,888)
Cash payments to suppliers	(2,485,697)	(3,458,269)
Net cash provided by (used for) operating activities	<u>2,756,371</u>	<u>(7,084,997)</u>
Noncapital financing activities:		
Cash received from ASEA/AFSCME Local 52 Health Benefit Trust	<u>—</u>	<u>1,284,944</u>
Net cash provided by noncapital and related financing activities	<u>—</u>	<u>1,284,944</u>
Investing activities:		
Investment income received	<u>714,581</u>	<u>642,317</u>
Net cash provided by investing activities	<u>714,581</u>	<u>642,317</u>
Net increase (decrease) in cash and cash equivalents	3,470,952	(5,157,736)
Cash and cash equivalents – beginning of year	<u>12,336,017</u>	<u>17,493,753</u>
Cash and cash equivalents – end of year	<u>\$ 15,806,969</u>	<u>12,336,017</u>
Reconciliation of operating income to net cash used for operating activities:		
Operating income	\$ 2,581,823	2,401,577
Adjustments to reconcile operating income to net cash provided by (used in) operating activities:		
(Increase) decrease in assets:		
Premiums receivable	(13,909)	18,563
Due from State of Alaska General Fund	81,180	46,586
Other receivable	—	533,413
Increase (decrease) in liabilities:		
Estimated claims incurred but not paid	(270,000)	(9,290,000)
Due to State of Alaska General Fund	58,372	—
Accrued expenses	318,905	(795,136)
Net cash provided by (used for) operating activities	<u>\$ 2,756,371</u>	<u>(7,084,997)</u>

See accompanying notes to basic financial statements.

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Notes to Financial Statements

June 30, 2003 and 2002

(1) Description

The following brief description of the State of Alaska Group Health and Life Fund (Plan), an internal service fund of the State of Alaska (State), is provided for general information purposes only. Participants should refer to the Select Benefits Information Booklet for more complete information.

(a) General

The Plan was established on July 1, 1997 to provide self-insured healthcare benefits to eligible employees of the State of Alaska. The Plan is an internal service fund of the State financial reporting entity and is included as such in the State's comprehensive annual financial reports. As of June 30, 2003 and 2002, there were approximately 5,300 employees, excluding dependents, covered by the Plan.

Prior to July 1, 1997, healthcare benefits for State employees were fully insured through the payment of premiums to an insurance company.

(b) Benefits

The Plan offers medical, dental, vision and audio benefits to eligible State employees and their dependents.

Eligibility

This Plan does not provide benefits to members of the following collective bargaining units, who chose to receive health coverage through a union trust:

- Labor, Trades and Crafts Unit
- Public Safety-Airport Security Unit
- Public Safety-Troopers Unit
- Correspondence Teachers Unit
- Masters Mates and Pilots
- Mt. Edgecumbe Teachers Unit
- General Government Unit (effective July 1, 2001)

All other permanent employees of the State are covered by the Plan, including permanent seasonal and permanent part-time employees who elect coverage.

The Plan also provides coverage for State legislators and elected officials.

Non-Flexible Benefits

Through June 30, 2001, employees who were members of the general government and correctional officers collective bargaining units were eligible for non-flexible healthcare benefits. The premium for these benefits was split between the State and the employee in accordance with the provisions of

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the appropriate collective bargaining unit. In addition to the benefits offered under the non-flexible program, employees were also able to obtain additional medical coverage under Option 1 of the State of Alaska Supplemental Benefits System. Premiums for this additional coverage are funded by pre-tax deductions from the employees' paychecks. Effective July 1, 2001, members of the general government collective bargaining unit were no longer eligible for non-flexible healthcare benefits under the Plan (note 5) and correctional officer members transferred to the flexible benefits program.

Flexible Benefits

Employees who are not covered through a union trust are eligible for flexible healthcare benefits. Under this program, employees are provided benefit credits by the State which they can use to purchase the benefits they want. Benefit credits equal the amount that the State contributes towards health benefits for all employees. The amount of benefit credits each employee receives is decided by the legislature and/or the appropriate collective bargaining agreement and can be adjusted each year. Each of the available options offers different benefits or pays benefits at different rates. If the cost of the benefit option selected by an employee exceeds the amount of their benefit credits, the difference is funded by the employee through pre-tax payroll deductions. If the cost of the benefit options selected by an employee is less than the amount of their benefit credits, the remaining benefit credits are contributed to a health care reimbursement account for that employee.

(c) Administration

The Plan is administered by the State's Division of Retirement and Benefits (DRB). DRB utilizes the services of a claims administrator, Aetna, to process all medical, dental, and prescription drug claims. Some of the managed-care vision benefits provided by the Plan are administered by Vision Service Plan (VSP).

(d) Funding

The Plan is self-insured for all benefits. The Plan's funding policy provides for the collection of premiums from employees, if applicable, and the State. Premium amounts are actuarially determined on an annual basis and adjusted as necessary. The State retains the risk of loss of allowable claims.

Amounts due from the State of Alaska General Fund represent reimbursements to be received from other funds for net amounts paid by the Plan on behalf of other Plans. Amounts due to the State of Alaska General Fund represent reimbursements to be made by the Plan to other funds for net payments made by other plans on behalf of the Plan

(2) Summary of Significant Accounting Policies

(a) Basis of Accounting

The Plan's financial statements are prepared using the economic resources measurement focus and the accrual basis of accounting. Premiums are recognized in the period in which they are due. Benefits are recognized when due and payable.

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(b) Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

(c) Investments

Investments are recorded at fair value. Fair value is “the amount that a plan can reasonably expect to receive for an investment in a current sale between a willing buyer and a willing seller – that is, other than in a forced or liquidation sale.”

The Plan is a participant in the State General Fund and Other Non-Segregated Investments (GeFONSI) pool. GeFONSI is comprised of the invested assets of the State General Fund and certain other funds that are commingled for investment purposes. GeFONSI invests primarily in pooled marketable debt securities.

The custodial agent determines the fair value of pooled marketable debt investments each business day using an independent pricing service. Fair value of debt securities has been established as the midpoint between the bid and asked prices. The cost of debt and equity investments is determined on the average cost basis.

GeFONSI investment income is distributed to participants as prescribed by statute or if appropriated by the state legislature.

(d) Statement of Cash Flows

For purposes of reporting cash flows, cash and cash equivalents include the Plan’s investment in GeFONSI. This balance has the general characteristics of demand deposit accounts.

(e) Federal Income Tax Status

The Plan is exempt from federal income taxes under Section 501(a) of the Internal Revenue Code.

(f) GASB Statement No. 34

The Plan adopted Governmental Accounting Standards Board Statement No. 34, *Basic Financial Statements—and Management’s Discussion and Analysis—for State and Local Governments* (GASB No. 34) on July 1, 2001, concurrent with the State of Alaska’s adoption of GASB No. 34. This statement, known as the “reporting model” statement, affects the way the Plan presents financial information. GASB No. 34 requires the basic financial statements of internal service funds to include statements of net assets, statements of revenues, expenses and changes in net assets and the statements of cash flows. Modifications made to the Plan’s financial reporting model as a result of the adoption of GASB No. 34 include presentation of management’s discussion and analysis (as required supplementary information), presentation of assets and liabilities in a classified format, cash

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flow statement using the direct method and reclassification of net assets according to certain criteria. The adoption of GASB No. 34 had no cumulative effect on net assets.

(3) Investments

The Governmental Accounting Standards Board (GASB) Statement No. 3 requires disclosure regarding custodial credit risk to indicate the chance of loss in the event a financial institution or third party holding the Plan's deposits or securities fails. At June 30, 2003 and 2002, the Plan's investments are represented by participation in GeFONSI, which primarily invests in pooled marketable debt securities. Although pooled fixed income securities represent the GeFONSI's share of ownership in the pool rather than ownership of specific securities, all of the underlying securities in the pools in which the GeFONSI participates are considered to be Category 1 as defined by GASB Statement No. 3. As such, investments are insured or registered, or securities are held by the State or its custodian in the State's name. Category 1 is the highest level of safekeeping security as defined by GASB.

(4) Claims Incurred but Not Paid

The liability for claims incurred but not paid represents the estimated amounts necessary to settle all outstanding claims, including those which are incurred but not reported, as of the balance sheet date. The Plan's reserve estimates are based primarily on historical development patterns adjusted for current trends that would modify past experience. The process of establishing loss reserves is subject to uncertainties that are normal, recurring and inherent in the health insurance business.

(5) Equity transfer to ASEA/AFSCME Local 52 Health Benefit Trust

During 2001, members of the General Government Unit (GGU) terminated their benefit coverage under the Plan. Under their collective bargaining agreement, effective July 1, 2001, the ASEA/AFSCME Local 52 Health Benefit Trust (Trust) began providing health insurance to eligible employees and their dependents of the GGU of the State of Alaska through a health trust. As of July 1, 2001, the Trust became liable for administration and payment of health claims for eligible bargaining unit members, their qualified spouses and dependent children. In accordance with the agreement between the State of Alaska, the Alaska State Employees Association/AFSCME Local 52 (Union), the Alaska State Employees Association, and the Trust, the Plan transferred \$4,350,000 to the Trust during 2001 to be used by the Trust for the benefit of eligible members and their dependents.

The Plan paid all claims incurred prior to July 1, 2001, by GGU members and their eligible dependents. As the cost of claims exceeded the cash reserve held by the Plan at June 30, 2001, the Plan billed the Trust in March 2002 on behalf of the GGU members for the shortage in accordance with the above agreement. The billing was also for amounts anticipated to be incurred by the Plan through June 30, 2002. The billing total was \$1,284,944. A final review of reserves was performed in November 2002, with no additional payment required.

(6) Securities Lending

Alaska Statute 37.10.071 authorizes the Commissioner of Revenue to lend assets, under an agreement and for a fee, against deposited collateral of equivalent market value. In January 2001, the Commissioner of Revenue entered into an agreement with State Street Corporation (the Bank) to lend short-term fixed

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income, pooled marketable debt and equity securities. The Bank, acting as the Commissioner of Revenue's agent under the agreement, transfers securities to broker agents or other entities for collateral in the form of cash or securities and simultaneously agrees to return the collateral for the same securities in the future.

At June 30, 2003 and 2002, the fair value of securities on loan attributable to the Plan totals approximately \$3,073,000 and \$1,096,000. The Commissioner of Revenue is able to sell any securities out on loan. There is no limit to the amount that can be loaned. International equity security loans are fully collateralized at not less than 105 percent of their fair value. All other security loans are fully collateralized at not less than 102 percent of their fair value. The Bank invests the collateral in a commingled investment pool; maturities of these investments generally did not match the maturities of the loaned securities because the lending agreements are terminable at will. The Bank may pledge or sell collateral upon borrower default. Since the Commissioner of Revenue does not have the ability to pledge or sell the collateral unless the borrower defaults, no assets or liabilities are recorded on the financial statements. There is limited credit risk associated with the lending transactions since the Commissioner of Revenue is indemnified by the Bank against any loss resulting from counterparty failure or default on a loaned security subject to limitation relating to war, civil unrest or revolution, or beyond the reasonable control of the Bank. The Bank and the borrower receive a fee from earnings on invested collateral.

For the years ended June 30, 2003 and 2002, there were no losses incurred as a result of securities lending transactions and there were no significant violations of legal or contractual provisions nor failures by any borrowers to return loaned securities.

(7) Contingency

The State is a defendant in a lawsuit filed by the Alaska Civil Liberties Union and seven same-sex couples with regards to the statutes limiting health insurance coverage to employees and their spouses and dependents, thus excluding coverage for domestic partners of employees. An adverse ruling against the State would increase the number of persons that would be covered by insurance paid by the Plan.

Although the ultimate outcome of the litigation discussed above is uncertain at this point in time, the Plan believes that an unfavorable outcome, if rendered, would not have a material adverse effect on its financial position or funding status. The Plan has not recorded an accrual related to the above lawsuit, because an unfavorable outcome in this matter is, in management's opinion, not considered probable but rather only possible, and the potential loss, if any, cannot be reasonably estimated at this time.